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# THE INFLUENCE OF THE FEDERAL RESERVE ACT UPON COMMERCIAL BORROWING

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Many bankers and a larger proportion of the business community have not as yet realized the tremendous influence which the Federal Reserve Act will have upon methods of commercial borrowing and the relations of the borrower to the banker. More than 7,600 national banks have joined the system, while with a few exceptions 15,000 state banks have thus far elected to pursue a policy of "watchful waiting." Although the member banks are numerically in the minority, yet their commanding resources and the influence which their operations exercise in the field of business are sufficiently great to cause the changes demanded by the Federal Reserve Act to eventually reach every class in the community. The development of the long-needed improvement in the methods of business borrowing will be gradual, but we are at the threshold of a long, and, let it be hoped, steady, wise and cautious development which will not be completed for many years.

The Federal Reserve Act contemplates that only certain well-defined classes of commercial paper shall be eligible for rediscount or purchase by the Federal reserve banks. The provisions of the act bearing upon this point are found in sections 13 and 14, and are as follows:

Upon the indorsement of any of its member banks, with a waiver of demand, notice and protest by such bank, any Federal reserve bank may discount notes, drafts and bills of exchange arising out of commercial actual transactions; that is, notes, drafts, and bills of exchange issued or drawn for agricultural, industrial, or commercial purposes, or the proceeds of which have been used, or are to be used, for such purposes, the Federal Reserve Board to have the right to determine or define the character of the paper thus eligible for discount, within the meaning of this Act. Nothing in this Act contained shall be construed to prohibit such notes, drafts, and bills of exchange, secured by staple agricultural products, or other goods, wares, or merchandise from being eligible for such discount; but such definition shall not include notes, drafts, or bills covering merely investments or issued or drawn for the purpose of carrying or trading in stocks,

bonds, or other investment securities, except bonds and notes of the government of the United States. Notes, drafts, and bills admitted to discount under the terms of this paragraph must have a maturity at the time of discount of not more than ninety days: *Provided*, That notes, drafts, and bills drawn or issued for agricultural purposes or based on live stock and having a maturity not exceeding six months may be discounted in an amount to be limited to a percentage of the capital of the Federal reserve bank, to be ascertained and fixed by the Federal Reserve Board. \* \* \* \*

The aggregate of such notes and bills bearing the signature or indorsement of any one person, company, firm, or corporation rediscounted for any one bank shall at no time exceed ten per centum of the unimpaired capital and surplus of said bank; but this restriction shall not apply to the discount of bills of exchange drawn in good faith against actually existing values. \* \* \* \*

SECT. 14. Any Federal reserve bank may, under rules and regulations prescribed by the Federal Reserve Board, purchase and sell in the open market, at home or abroad, either from or to domestic or foreign banks, firms, corporations, or individuals, cable transfers and bankers' acceptance and bills of exchange of the kinds and maturities by this Act made eligible for rediscount, with or without the indorsement of a member bank. \* \* \* \*

Every Federal reserve bank shall have power: \* \* \* \*

(c) To purchase from member banks and to sell, with or without its indorsement, bills of exchange arising out of commercial transactions, as hereinbefore defined;

It is very important at the outset to note that the act specifically excludes notes, drafts or bills of exchange "covering merely investments or issued for the purpose of trading in stocks, bonds or other investment securities," that commercial paper, to be eligible, must "arise out of actual commercial transactions" which are explained to be paper, "the proceeds of which have been used or are to be used for such purposes." The inclusion of paper, the proceeds of which *are to be used*, opens up one of the most difficult administrative problems in connection with the matter of commercial borrowing, for the Federal Reserve Board, to whom, it will be remembered, is given the task of defining in detail the classes of paper which are eligible for rediscount, has had great difficulty in formulating a workable definition which will accord with the provisions and spirit of the act. A recital of the problems which have confronted the Board, and the reasons for the various regulations as promulgated, is the subject matter of this article.

The purpose of the Federal Reserve Act is to exclude all classes of paper, which are not self-liquidating. Mr. Samuel Untermyer well phrased the test which must be applied when he said:

Commercial paper, as I understand it, is that which represents an actual transaction in the consummated purchase and sale of merchandise intended for resale and consumption. It must answer the test of being an obligation that automatically discharges itself in the ordinary course of business.

Mr. Festus J. Wade, one of the committee of the American Bankers Association, in his statement before the Senate committee declared that:

We recommend as a committee that notes be based on what is known as commercial paper: that is to say, paper that is issued for the purchase of the products of the earth, of the farm, of the factory, of the mine, of the commercial establishment. That represents the commerce that is gradually consumed within a year or within a six-month period. . . . Every bale of cotton that is ginned is consumed within a short period of time. Every bushel of wheat is consumed within a short period of time, every bolt of calico on an active merchant's shelf gradually goes into consumption, and they issue, in order to move that commerce, what is known as commercial paper, which matures within a short time, and it consumes itself, and therefore brings back from the Nation all over the money to meet the obligation of these short-time notes. . . . The well-regulated commercial house never renews its paper.

On February 7, 1914, the Reserve Bank Organization Committee addressed a circular letter to a number of the leading clearing house associations of the country, asking each association to suggest a definition of commercial paper, which would meet the terms and spirit of the Federal Reserve Act. While it is impossible for us to go at length into the replies of the several clearing house associations, yet a brief review of the tenor of the responses will serve to indicate the remarkable unanimity of opinion among bankers as to the necessity for an improvement in certain classes of commercial paper. The responses of the clearing houses indicated that almost without exception the problem was recognized to be that of preventing abuses in the issue of single-name paper. Single-name paper includes all notes made to the order of the maker and endorsed by him; that is to say, paper where there is only one firm or name upon it. In some cases the paper of corporations bears the personal endorsement of leading stockholders or officials, but even when this is the case it is generally known as single-name paper.

The Boston clearing house in its reply pointed out the manifest disadvantages in declaring single-name ineligible for rediscount but declared that: "We believe, however, that it is desirable to encourage the making of strict 'Commercial Paper,' that is notes or accept-

ances for goods given by the buyer to the seller, and that this would benefit not merely the banks but the general credit situation in the country as well. We recommend that the Federal reserve banks provide that strict 'commercial paper,' as defined above, be discounted at a lower rate than single-name paper by the Federal reserve bank."

The Philadelphia clearing house declared that: "Great care, however, should be exercised by the Federal Reserve Board in not permitting too free an issue of currency against single-name paper" . . . . and recommended that: "In order to place a check upon too free an issue of single-name commercial paper and its rediscount . . . . the Federal Reserve Board might require that all single-name paper, to be eligible for rediscount, must be registered at the Federal reserve bank or branch in the district where the drawer's business is located." The reply set forth in detail the conditions which should govern the registration of such paper.

The Seattle clearing house recommended that "the established custom of the vendor carrying the account of the purchaser in an open form should be discouraged, and as rapidly as possible supplanted by substituting for the account short time notes (or acceptances)." The Denver clearing house took the same position, recommending that "obligations of this nature should eventually be converted into bills of exchange so that their character may be discernible at a glance."

It is worthy of note that the New York Clearing House took the most advanced position of all in its reply. While recognizing that the practice of financing large business enterprises through the sale of single-name paper could not be discontinued abruptly, the reply declared that: "We deem it a matter of the utmost importance that there should be a general restoration of the former conditions in this respect. The use of commercial acceptances abroad is a prime factor in the open discount market and a similar system should prevail in this country. The purpose of issue of this class of paper is apparent on its face; and as it retires itself automatically, it is an efficient aid in furnishing an elastic circulation."

The National Association of Credit Men, which also had been requested to consider this matter, replied that "there should be encouraged a gradual substitution in part of the two-name paper or commercial bills evidencing the sale and delivery of merchandise

for the rigid and open account credit system, so that it may not be deemed unusual for a note or acceptance to pass from buyer to seller as the evidence of merchandise bought and delivered," and recommended that in order to "assist the cultivation of the desirable commercial bill as a feature of our credit system, it must be accorded some distinct recognition other than the educative process which should gradually attract and win business men to its support. This recognition could be (a) limiting the one-name paper to 90 per cent of the total accepted for rediscount during the first year, to 85 per cent the second, and 75 per cent the third year; (b) allowing to the two-name paper or commercial bill a very slightly lower rate of discount."

As contrasted with this position, the Merchants Association of New York City made a vigorous protest against the elimination of single-name paper, contending that it would involve a radical change in the methods of handling business; would largely increase the volume of clerical work, through the necessity of handling hundreds of small notes instead of a few large ones, and make more difficult the marketing of such small units through note brokers.

The Federal Reserve Board has not gone so far as many of the Clearing House Associations have recommended. It has not excluded single-name paper from the privilege of rediscount. It has not given to the accepted commercial draft a lower rate of discount than that enjoyed by the single-name paper, nor has it specified the proportion of total rediscounts which can be made up of each class of paper, nor has it adopted the recommendation concerning the registration of single-name paper.

The first regulations concerning commercial paper were promulgated by the board on November 10, 1914. These regulations provided, in substance, that all eligible paper, when offered for rediscount after January 15, 1915,

shall show on its face, or by indorsement, a statement substantially to the following effect:

Eligible for rediscount with Federal Reserve Banks under regulations of the Federal Reserve Board Circular No. 13—

Credit File No. ....  
District No. ....  
Name of member bank .....

The credit file number shall refer to evidence in possession of the member bank that the proceeds of such notes, drafts, or bills of exchange, under the terms of the loans made or to be made, were, or are to be, used for agricultural, industrial, or commercial purposes, as required by Section 13 of the Federal Reserve act and as imposed by Regulation No. 2 of the Federal Reserve Board, and such credit files shall be open to inspection by any examiner appointed by the Controller of the Currency or selected by the Federal Reserve Bank discounting same, and copies of such files, or any part thereof, shall be furnished to the officers of the Federal Reserve Bank upon request.

The credit files referred to should contain not only evidence of the purpose or purposes for which such loans are made, but also full and complete information as to the financial responsibility of the borrower, including a short general description of the character of the business, balance sheet, and profit and loss account of the borrower. Assets should be divided into permanent or fixed investments, slow assets, and quick assets. On the liability side should be shown capital, long-time loans, and short-term loans. Short-term loans should be in proper proportion to quick assets, and the statement should contain satisfactory evidence that short term paper is not being sold against permanent or slow investments. The statement should, furthermore, show the maximum aggregate amount up to which the concern supplying this paper expects to borrow on short credit or sale of its paper, and the individual, firm, or corporation giving the statement should obligate himself or itself to obtain the member bank's consent before exceeding the agreed limit. The affixing of the stamp stating such paper to be eligible for rediscount will be considered a solemn and binding declaration by the member bank that the statement has been examined from this point of view and that the paper bought complies with all the requirements of the law and of the regulations hereby imposed.

An analysis of this regulation discloses the radical character of the requirements which it imposed. In the first place, the paper, in order to be eligible for rediscount, must be that of borrowers concerning whom the constituent bank offering the paper for discount has certain specified credit information in its credit file. In order to insure that this information is at hand, the member bank was required to affix the number of the credit file containing the information concerning this borrower. Little was left to the discretion of the bank concerning the character of this information. A balance sheet and a profit and loss account, arranged in a prescribed order and calling for prescribed information, were required. By the first, the assets and liabilities of the firm—fixed, slow and quick—must be shown; by the second, the firm's profits and the method of distributing them would be made known, and in addition, the signed and sworn statement should show the maximum

aggregate amount up to which the concern expected to borrow in the immediate future.

Business organizations protested against the severity of these requirements. It was suggested to the Board that the requirements were too radical; that the rank and file of the member banks did not have credit information concerning all of their borrowers, and that until such information could be procured, the member banks would be in a position of having paper which could not meet the technical requirements, and hence could not be rediscounted, irrespective of its goodness. This would leave the member banks in an unprotected position and might subject the system to too grave a danger in case of any unforeseen emergency. It was represented to the Board by many banks that it would be very impolitic to impose a general requirement of such a nature at the beginning. Business men would resent these inquiries and they might cost the national banks many customers who would go to state institutions where such requirements would not be observed. Particular umbrage would be taken against the disclosure of profits, which business men would feel might be used to their disadvantage, should the statements come under the eyes of directors or others directly or indirectly competing with them.

The requirement that a business firm should covenant as to the maximum amount of its borrowing on commercial paper, was also much criticized. It was pointed out that it would be impossible under present-day conditions for a large borrower, selling single-name paper, to get into communication with every bank which might hold its paper in case some unforeseen contingency might make it expedient to increase current borrowings. Single-name paper is widely distributed through note brokers, who jealously guard the names of their customers as a valuable business secret. Moreover, even if the note brokers coöperated, it might be difficult to locate all of the paper of a given firm, for frequently such paper is sold from one bank to another in inter-bank dealings.

In consequence of the various representations and objections which were made, the Federal Reserve Board announced on December 19, that it would postpone the going into effect of Regulation No. 4, scheduled for January 15, and later, on January 25, the board superseded this regulation with a new regulation (Regulation B, Series of 1915) which materially softened the requirements which



must be met by eligible commercial paper when offered for rediscount. The Board left to each Federal reserve bank the right to determine the method of certifying the eligibility of commercial paper, thus enabling the reserve banks to frame their procedure with due regard to local conditions and customs.

The Board required in substance that any member bank applying for rediscount must certify in its letter of application, over the signature of a duly authorized officer, that to the best of its knowledge and belief the bill was issued for one of the purposes authorized by the Federal Reserve Act. The letter of application must also state whether the paper is depositor's or purchased paper or paper rediscounted for other member banks, and also whether statements are on file.

Regulation B provides that when it does not appear that such statements are on file, except in the three cases where statements are waived,—

the Federal Reserve Bank shall satisfy itself as to the eligibility of the paper offered for rediscount, and member banks will be expected to use such statement forms, identifying stamps, etc., as may be prescribed by the respective Federal Reserve Banks. Any member bank rediscounting with a Federal Reserve Bank paper acquired from another member bank, with the indorsement of such member bank, may accept such member's certification regarding the character of the paper and the existence of the necessary statements.

Statements of the borrower's financial condition may be waived where notes offered for rediscount have been discounted by member banks *for any of their depositors*, in three cases:

(1) If the bill bears the signatures of the purchaser and the seller of the goods and presents *prima facie* evidence that it was issued for goods actually purchased or sold; or

(2) If the aggregate amount of obligations of such depositor actually rediscounted and offered for rediscount does not exceed \$5,000, but in no event a sum in excess of 10 per centum of the paid-in capital of the member bank; or

(3) If the bill be specifically secured by approved warehouse receipts covering readily marketable staples:

*Provided*, however, That the bank shall certify to these conditions on the application blank in a manner to be designated by the respective Federal Reserve Banks.

These three conditions contemplate, in substance, the waiving of borrower's statements in the case of accepted commercial drafts and where the paper is that of the small farmer, business man or

retailer. It should be noted that the \$5,000 limit mentioned in paragraph 2 above does not necessarily contemplate that statements shall be offered where the borrower has *sold* paper to an amount exceeding \$5,000, but that the limit of \$5,000 covers the paper offered for rediscount. In other words, the borrower might have discounted \$25,000 worth of paper, but so long as the bank chooses to hold \$20,000 or more of this paper, rediscounting \$5,000 or less, the statement is not required. The third exemption covers, in substance, commercial paper secured by cotton, grain or other warehouse receipts. In this case the value of the collateral is presumed to be sufficient to warrant the waiving of the requirement of a borrower's statement.

The Federal Reserve Board has recommended that these requirements be imposed at once in the purchase of paper from note brokers. The regulation, however, does not become effective until July 15 of this year, thus giving the banks time to adjust their affairs to meet the requirements of the Board.

The Board recommends that every member bank maintain a credit file which "shall contain original signed statements of the financial condition of borrowers, or true copies thereof, certified by a member bank or by a notary public, designating where the original statement is on file. Statements shall contain all the information essential to a clear and correct knowledge of the borrower's credit and of his method of borrowing."

The Board specifies in a general way the character of information which should be in the credit files of member banks. Such files should contain information concerning the nature of the business or occupation of the borrower, the extent of his indebtedness and his financial responsibility. Where the borrower is a firm or corporation, a balance sheet showing quick assets, slow assets, permanent or fixed assets, current liabilities and accounts, short-term loans, long-term loans and capital and surplus should be at hand. Furthermore, the contingent liabilities, such as endorsements, guaranties, etc., should be set forth in detail, and information should be given respecting any mortgage debt and as to whether there is any lien on current assets.

It is too early to accurately estimate the effect of these requirements. The Board declares that in making the changes in its regulations, it "has not modified its views upon the general principles"

expressed in its regulations of 1914 "as being of fundamental importance in the best development of the new system."

The new requirements of the Board were prompted by a desire to slowly educate their customers in giving statements. The board in its 1915 regulations enjoins the member banks "to do their utmost to accustom their borrowers in furnishing such statements," even where the furnishing of statements is not required under the three classes of exemptions noted above. It is very clear to anyone who has carefully perused the regulations of the Federal Reserve Board that a progressive development in scope and detail of the regulations is contemplated, with a view to improving the general quality of commercial paper offered for discount, both through the exclusion of undesirable paper given by overextended borrowers and more particularly with a view to requiring the payment of paper when due, rather than its renewal, as has too often been the practice in the past. This work will occupy a period of years and if done carefully and without violent and arbitrary changes will be of the greatest assistance to the business men of this country. It will raise commercial paper to the proud position of being the best class of banking asset—a position held by such paper in every country in Europe. This will mean lower rates of interest to the business man and greater security in his dealings with the bank. With the paper of weak or reckless borrowers eliminated, the losses sustained by banks through the purchase of this class of investment will be materially reduced, thus leading to the investment of a larger amount of money in this manner.

The greatest incentive to increased investments in commercial paper by member banks will be the fact that commercial paper, meeting the requirements of the board, can be converted into cash whenever an emergency arises through the rediscount of it with the Federal reserve banks. This is the only class of banking asset which a bank may certainly count as being always liquid. Commercial paper will largely supersede the call loan as the secondary reserve of our member banks, thus diverting a large amount of money, which has heretofore, of necessity, been used in more or less speculative transactions, into commercial channels to the great profit of our country and the welfare of our banks.